Fifth Annual Survey

2011 Hedge Fund Outlook: **Brighter Days Ahead?**

The trend toward the institutionalization of the hedge fund industry continues, as enhanced compliance and operational best practices have helped to restore investor confidence. Bolstered by increasing allocations from institutional investors, as well as a more stable economic environment, hedge fund managers report the highest level of optimism recorded since the crisis.

April 2011

Rothstein Kass

April 2011

Rothstein Kass

When we commissioned our annual survey of hedge fund managers in the first quarter of 2009, at the height of the financial crisis, the alternative asset community had already seen its best days, according to the most vocal detractors. These critics were emboldened as many funds struggled to meet redemption requests underscored by a decline in investor confidence. However, in our experience as the premier professional services firm to the alternative investment community, the entrepreneurs who drive the business have repeatedly shown resilience. Therefore, we were not particularly surprised by the extreme level of confidence hedge fund managers expressed, even as they acknowledged the many challenges ahead. As we said at the time, many investors would look back and wish they had not redeemed their investments.

As we announce the results of 2011 outreach—our fifth annual survey on hedge fund industry trends—it appears that much of this confidence was justified. By maintaining their investment focus, many funds were able to recognize value and seize opportunity as others watched from the sidelines. As a result, the hedge fund industry has dynamically benefited from the market recovery. Over the long-term, however, the industry has persevered by adapting to meet the demands of the sophisticated investment communities it serves, even as the investor base profile has continued to evolve.

Looking back to 2007, only 20% of the hedge fund managers we surveyed expected institutional assets to dominate the alternative investment landscape; fewer than 10% anticipated increased industry regulation. In the ensuing years, these perspectives have shifted dramatically. Institutional allocations from sources including pension, endowments, sovereign wealth and family businesses have grown to become the largest source of new investment capital to hedge funds. Meanwhile, the financial crisis has led to an enhanced compliance focus that has permeated all aspects of hedge fund operations. It has also brought extensive legislative reform that should finally dispel the notion that the industry is not regulated. Our 2011 survey reveals that as hedge funds become more institutional in nature, they are adding to executive management teams, with a strong emphasis on operations, compliance and technology, as well as on capital raising and investor communications.

With pension plans working to overcome significant funding shortfalls magnified by the crisis, many have recently announced increased allocations to non-traditional investments, including hedge funds and private equity funds. Some observers contend that larger funds will disproportionately benefit from these activities, as institutional investors have exhibited a decided preference for allocations to established vehicles. Institutional investors are looking to ensure that the fund has institutional-quality best practices and policies needed to promote long-term stability. It is incumbent that emerging managers adopt this model to achieve greater success in attracting institutional and seed capital amid intense competition from their larger, branded counterparts.

We hope that you will find our latest report illuminating and compelling. We encourage you to contact us to discuss our findings.

Sincerely,

Howard Altman
Co-CEO & Principal-in-Charge of the Financial Services Group
Rothstein Kass

Key Themes

- The overall outlook for the hedge fund industry will continue to improve in 2011, with hedge fund managers anticipating more hedge fund launches and fewer closures.

- Amid ongoing regulatory examination, hedge funds are implementing operational improvements and enhancing communications efforts, while continuing to outsource non-investment functions.

- While competition is anticipated, hedge funds plan on raising money this year. Institutional investors, including pension funds, endowments, sovereign wealth funds and family offices, are all seen as excellent sources of new investment capital.

- As institutional investors have become more influential, they have exhibited a preference for allocations to larger funds. For new funds, seed capital is becoming more critical to effectively achieving the scale required for success.

Demographics

The Research

In January 2011, Rothstein Kass conducted an Internet survey of 313 hedge fund managers. The research gathered industry perspectives on a wide range of issues, including capital-raising intent, operational considerations and the regulatory environment.

The majority of the hedge funds we surveyed (70%) manage less than $500 million and the balance (30%) manage $500 million or more (Exhibit 1).

In some cases, critical differences were seen between the hedge fund managers controlling funds with $500 million or less AUM and those controlling funds with $500 million or more AUM.

About 60% of hedge funds surveyed have been in existence for at least five years (Exhibit 2) and consequently reported greater AUM than their younger counterparts.

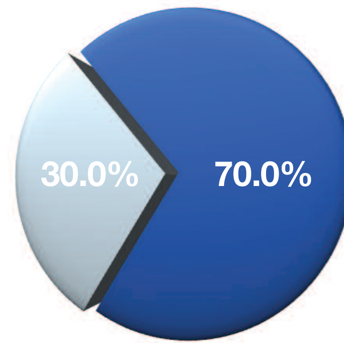


Exhibit 1: AUM

<$500M	**70.0%**
$500M+	30.0%

N = 313 hedge funds

Exhibit 2:

Years in business

	<$500M	$500M+	Weighted Average
1-3 years	37.4%	5.3%	27.8%
3-5 years	17.4%	8.5%	14.7%
5 years or more	45.2%	86.2%	57.5%

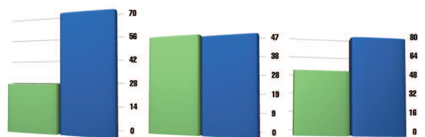
N = 313 hedge funds

Responses indicate that even as regulators finalize guidelines for SEC investment manager registration ($150 million in AUM for pooled vehicles), a substantial portion of larger funds have already started this transition. Nearly half of the investment managers of the larger hedge funds are currently registered (compared to roughly 20% of smaller funds) (Exhibit 3).

With the threshold for SEC registration now set at $150 million in AUM, registration of larger funds will continue to surpass that of smaller funds in the near term (Exhibit 4).

Exhibit 3:

Investment managers currently registered with the SEC



	<$500M	$500M+	Weighted Average
Yes	19.6%	46.8%	27.8%
No	77.2%	45.7%	67.7%

N = 313 hedge funds

Exhibit 4:

Plan to register investment advisors with the SEC in 2011

	<$500M	$500M+	Weighted Average
Yes	29.7%	50.0%	35.8%
No	56.6%	31.9%	49.2%

N = 313 hedge funds

"Despite the persistent notion that the hedge fund industry is unregulated, the reality is that many firms, particularly those with large concentrations of institutional investors, have registered as investment advisors with the SEC prior to the 2010 Dodd-Frank bill. Recognizing that enhanced disclosures will help promote investor confidence, the hedge fund industry has worked with regulators to set standards that achieve this goal while maintaining proprietary fund information and investor privacy," said Howard Altman, Co-CEO of Rothstein Kass and Principal-in-Charge of the firm's Financial Services Group. "This cooperation reflects a general trend toward improved communications efforts within the alternative investment community. The flow of institutional capital ensures that regulators will continue to closely monitor the hedge fund sector. The dialogue established in the aftermath of the global economic crisis could lead to a more informed regulatory process that provides investors and regulators appropriate information and disclosures."

Industry Outlook

Hedge fund managers surveyed had a generally positive overall outlook for the industry in 2011, with only about a third expecting a difficult year ahead (Exhibit 5).

Exhibit 5:

2011 will be a difficult year for the hedge fund industry

	<$500M	$500M+	Weighted Average
Agree	34.7%	26.6%	32.3%
Disagree	52.1%	61.7%	55.0%
Uncertain	13.2%	11.7%	12.7%

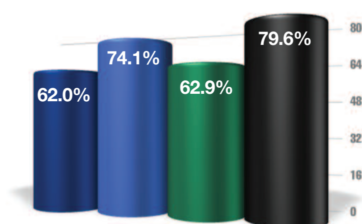
N = 313 hedge funds

"When we surveyed hedge fund managers in 2009, nearly 90% agreed that the community was facing a trying year. By the first quarter of 2010, the mood had improved only slightly, with almost 70% forecasting a difficult year ahead. By implementing institutional-quality best practices and maintaining investment focus, many hedge funds have enjoyed a resurgence coinciding with the broader market recovery from March 2009 through the end of 2010. The dramatically higher level of optimism expressed in our 2011 survey data suggests that hedge fund managers continue to see attractive investment opportunities as the global economy improves," said Mr. Altman.

Initial indications that hedge fund managers are optimistic about the industry's recovery are reinforced by their opinions regarding the pace of launches, closures and redemptions (Exhibit 6). A better environment for hedge funds is expected to result in more hedge fund launches and fewer hedge fund closures. Nearly 80% of hedge fund managers anticipate the pace of redemptions will meaningfully slow in 2011. Additionally, more than 60% of the managers see hedge funds benefiting from an inflow of talent from other segments of the financial services industry.

Exhibit 6:

Implications for a better 2011



Hedge funds will benefit from an inflow of talent from other segments of the financial services industry.	62.0%
There will be more hedge fund launches in 2011 than in 2010.	74.1%
There will be fewer hedge fund closures in 2011 than in 2010.	62.9%
The pace of redemptions will slow in 2011.	79.6%

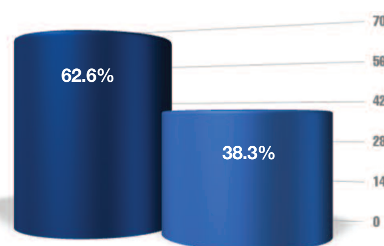
N = 313 hedge funds

"There is strong consensus among survey participants that the pace of fund launches will increase while closures and redemptions decline. Across 2010 and the early part of 2011 we continue to see this optimism actually play out. Rothstein Kass has seen in practice a significant uptick in launches coupled with a significant decrease in fund closures," said Vincent Calcagno, Principal-in-Charge of Rothstein Kass' Beverly Hills office. "It's interesting to note that according to our research, perceptions regarding fund launches and closures are nearly identical to those reported in January 2008. This quick turnaround occurred, in large part, because the alternative investment industry continues to attract the brightest as well as the most motivated and entrepreneurial talent."

When launching new hedge funds, seed capital will be more critical to success, according to more than 60% of the hedge fund managers surveyed (Exhibit 7). At the same time, nearly 40% of the hedge fund managers expect pensions and endowments to become involved in seed capital financing.

Exhibit 7:

Seed Capital



Hedge funds launching in 2011 will be more dependent on seed capital investment than in 2010	62.6%
Pensions and endowments will increasingly be involved in seed capital investments	38.3%

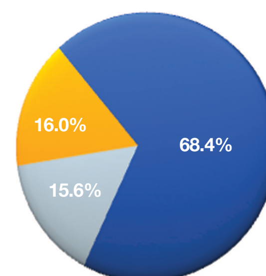
N = 313 hedge funds

"On the surface, it appears that increasing compliance costs and institutional investors' intent to invest in to larger, established funds will discourage entrepreneurial managers from launching new hedge funds, but our experience suggests otherwise," said Chris Mears, Principal-in-Charge of Rothstein Kass' New York Metro Financial Services Group. "The industry talent pool remains sufficiently deep that there are always managers with the confidence to serve an unfilled niche in the marketplace. As they embark, many are bolstered by an inflow of seed capital. The flip side is with the abundance of managers competing for assets, sources of capital will continue to be selective."

With economic conditions normalizing, nearly 70% of the hedge fund managers polled anticipate increased consolidation in the asset management space in 2011 (Exhibit 8). We asked all respondents to identify the most likely catalyst, assuming increased consolidation activity (Exhibit 9). For nearly two-fifths of the hedge fund managers, the answer was regulatory developments and compliance costs. Fund size did not differentiate response. Slightly fewer indicated that consolidation would be driven by the desire to acquire clients and grow market share.

Exhibit 8:

Consolidation in the asset management space will intensify in 2011

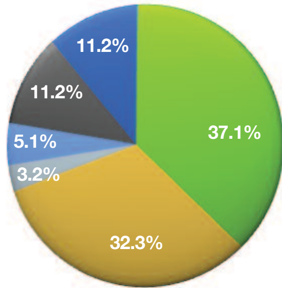


Expect increasing consolidation	68.4%
Don't expect increasing consolidation	15.6%
Uncertain	16.0%

N = 313 hedge funds

Exhibit 9:

Most likely catalyst for industry consolidation



Regulatory developments/ compliance costs	37.1%
Grow market share/ client acquisition	32.3%
Providing clients with a greater range of strategies	11.2%
Talent acquisition	3.2%
Other	5.1%
Uncertain	11.2%

N = 313 hedge funds

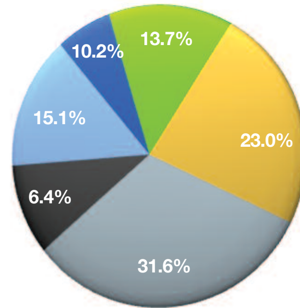
"In the next few years, hedge fund industry assets under management could surpass $3 trillion, but the sector remains surprisingly fragmented. This has benefited investors by offering them a wide range of strategies and products," said Mr. Altman. "Following the financial crisis, capital has invested in large funds, 'barbell right.' The issue is how funds in the middle, and those 'barbell left,' will be able to brand and raise capital."

Investing

The recent credit crisis and the explosion of the "housing bubble" proved disastrous to the economy and badly wounded investor confidence. Consequently, investors are on guard for signs of the next potential market disruption. As noted, hedge fund managers are seeing a brighter future, and that extends to their current investment outlook. While nearly a third of the hedge fund managers see a possible crisis forming in commodities and nearly a quarter see an issue in gold, the threat is not seen as immediate.

Exhibit 10:

The next "investing bubble" is most likely to occur in which sector



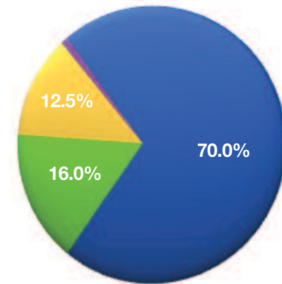
Commodities	31.6%
Gold	23.0%
Green energy	13.7%
Financial services	6.4%
Other	10.2%
Uncertain	15.1%

N = 313 hedge funds

Seventy percent of managers expect any investment bubble will not burst until between 2012 and 2015 (Exhibit 11). That allows for further monitoring of valuations and overarching economic conditions to capitalize and profit from any burst of the bubble.

Exhibit 11:

Expect the "bubble to burst"



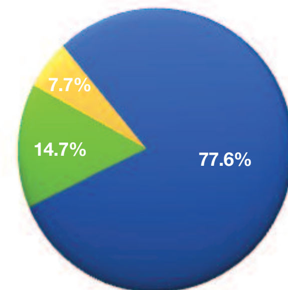
2012 - 2015	70.0%
2015 - 2020	16.0%
In 2011	12.5%
2020 or beyond	1.5%

N = 313 hedge funds

When it comes to investing, nearly four out of five hedge fund managers believe the use of leverage today, compared to 2008, is significantly less (Exhibit 12).

Exhibit 12:

Hedge funds use significantly less leverage now than prior to the 2008 credit crisis



Agree	77.6%
Disagree	14.7%
Uncertain	7.7%

N = 313 hedge funds

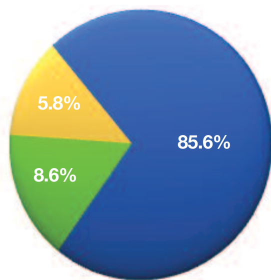
"The misconception that hedge funds' use of leverage contributed to the global economic crisis has been widely dispelled. In fact, hedge funds then used—and continue to use today—significantly less leverage in their investments than traditional financial services

institutions. Still, as institutional capital has become more influential, the hedge fund industry has generally scaled back leveraged investing further," said Kelly Easterling, Principal-in-Charge of the Rothstein Kass Walnut Creek, California, office. One possible scenario going forward is if enhanced disclosures lead to greater investor confidence, we might see leverage ratios climb again, especially if competition for quality investments becomes intense."

As research reveals, institutional investors are playing a very critical role in capital raising. At this stage, when targeting institutional assets, it's advantageous for a hedge fund to avoid high concentrations of illiquid portfolio holdings (Exhibit 13).

Exhibit 13:

Institutional investors will be more averse to high concentrations of illiquid portfolio holdings



Agree	85.6%
Disagree	8.6%
Uncertain	5.8%

N = 313 hedge funds

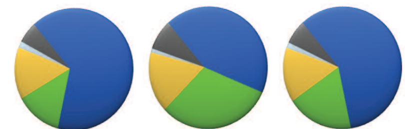
"Investors of all classes were motivated to examine liquidity requirements after the market movement experienced in recent years. During the crisis, some funds were compelled to sell profitable positions to meet redemption requests and were left holding a larger concentration of illiquid assets in their portfolios," said Joseph Pacello, a Tax Principal in the Rothstein Kass Financial Services Group.

Capital Raising

Nearly 60% of hedge fund managers plan to raise assets under management by 25% or more (Exhibit 14). This is significantly more pronounced among the funds with $500 million or less AUM (65%) compared to those funds with $500 million or more AUM (40%). Very clearly those funds with less AUM are looking to dramatically boost their capital-raising efforts. At the same time, about 30% of the larger funds are looking to increase AUM by raising monies, but by less than 25%. Only about 15% of the hedge funds are not actively seeking new capital.

Exhibit 14:

Planning to raise new investment capital in 2011



	<$500M	$500M+	Weighted Average
Plan to increase AUM by 25% or more	64.4%	42.6%	57.8%
Plan to increase AUM by under 25%	13.2%	30.9%	18.5%
Not actively seeking new investment capital	14.6%	17.0%	15.3%
Expect AUM to decrease in 2011	1.8%	1.1%	1.6%
Uncertain	6.0%	8.4%	6.8%

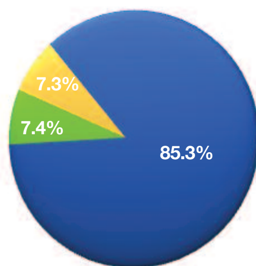
N = 313 hedge funds

"When we commissioned our first survey on hedge fund industry trends in 2007, we deliberated about whether the fund raising question even needed to be asked. As expected, nearly all of survey participants that year reported their intent to raise additional investment capital. By the first quarter of 2010, however, fewer than 70% of managers surveyed indicated that they expect to raise significant capital in the year ahead. Our latest survey shows that number climbing back above 75%, but not yet attaining pre-crisis levels. While very few funds are closed, many more may be in 'soft closing' mode. Others are in an incubation period as they work to establish performance and are relying more heavily on general partner investment and seed capital before opening the fund to outside investors," said Mr. Altman.

The widespread intent to raise capital translates into a more competitive environment (Exhibit 15). This increased competition is going to have a strong impact on the way hedge funds operate and brand themselves. For instance, about three-quarters of hedge fund managers believe that the financial commitment of the general partners will play a more meaningful role in motivating others to invest (Exhibit 16).

Exhibit 15:

Competition for hedge fund investors will increase in 2011

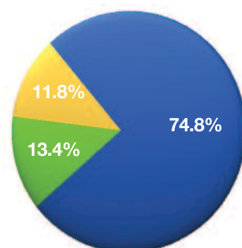


Agree	85.3%
Disagree	7.4%
Uncertain	7.3%

N = 313 hedge funds

Exhibit 16:

General partner investment in hedge funds will become a greater consideration for investors allocating to hedge funds



Agree	74.8%
Disagree	13.4%
Uncertain	11.8%

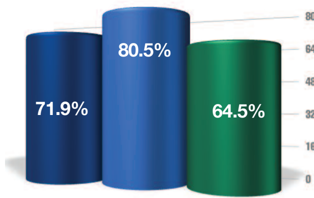
N = 313 hedge funds

"Institutional investors have fiduciary duties and are evaluating all conceivable factors in selecting hedge fund managers to manage assets. Competition is emerging from both other hedge funds and products that promise 'hedge-fund-like returns,' such as ETFs. One critical factor is alignment of interest. For many investors, nothing sends a stronger signal of confidence than a general partner that invests substantial personal capital alongside that of investors," said Mr. Altman.

Overall, there is a strong perception that, in 2011, institutional investors will play a dominant role in sourcing new capital to hedge funds (Exhibit 17). Moreover, there's a general consensus that institutional investors will gravitate to larger hedge funds. This is often the case because by allocating to larger, more established hedge funds, the institutional investors are seeking to mitigate selection risk. Regardless of fund size, the majority of hedge fund managers surveyed believe that firms will have to offer special terms to attract significant capital from pension funds and sovereign wealth investors.

Exhibit 17:

Institutional investors



Institutional investors will be the dominant source of new capital in 2011	71.9%
Institutional investors will continue to allocate to larger hedge funds	80.5%
Hedge funds will more frequently offer special classes of interest and terms to pension funds and sovereign wealth investors	64.5%

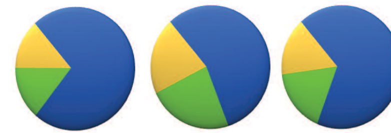
N = 313 hedge funds

"Roughly 20% of hedge fund managers we surveyed in 2007 expected that by 2010 institutional investors would be the dominant source of capital to the hedge fund industry. Yet by the time we commissioned our annual survey in 2010, nearly 70% believed that this class would represent a significant source of capital in the year ahead," said Mr. Altman. "At this stage, institutional assets represent a substantial portion of hedge fund portfolios. Fund managers have come to appreciate the stability, long-term view and stream of investment capital institutional investors provide. As a result, our survey indicates that funds are showing a greater willingness to offer special terms to encourage larger capital allocations."

Nearly 70% of hedge fund managers believe family offices will be an important source of new capital in 2011 (Exhibit 18). Family offices are seen as being more important to smaller hedge funds (72%) compared to larger hedge funds (55%).

Exhibit 18:

Family offices will be an important source of new capital in 2011



	<$500M	$500M+	Weighted Average
Agree	71.7%	55.3%	66.8%
Disagree	14.6%	23.4%	17.3%
Uncertain	13.7%	21.3%	15.9%

N = 313 hedge funds

"As the industry grows more institutional in its practices, hedge funds remain a critical component of the investment portfolios of many wealthy individuals and families. Because they typically employ a long-term investment approach and offer greater liquidity relative to other alternative investment classes, hedge funds can be effectively employed in support of both asset protection and wealth creation strategies. At the same time, there is a growing awareness among the high-net-worth community of the importance of incorporating investment objectives into an overarching wealth management strategy. Many have found that a family office – approaching investments, lifestyle and estate planning concerns as interrelated functions – is ideally structured to support long-term goals. As a result, hedge funds are again anticipating strong asset flows from this sector in 2011," said Rick Flynn, a Principal at Rothstein Kass and head of the firm's Family Office Group.

More than half the hedge fund managers see consulting firms being more influential in allocating institutional capital (Exhibit 19). This is more evident among larger hedge funds (63%) than smaller hedge funds (51%).

Exhibit 19:

Consulting firms will be more influential in allocations of institutional capital

	<$500M	$500M+	Weighted Average
Agree	50.7%	62.8%	54.3%
Disagree	24.7%	17.0%	22.4%
Uncertain	24.6%	20.2%	23.3%

N = 313 hedge funds

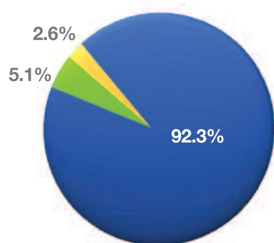
"Institutional investors considering allocations to the alternative investment industry now select from an almost limitless roster of products and strategies, each with a distinct value proposition for investors. In fact, this diversity means that the hedge fund community offers products ideally suited for virtually all accredited investors. However, when confronted with this potentially confounding array of choices, many funds have turned to outside consultants to help assess viable options," said Jeff Kollin, head of the Financial Services Advisory practice at Rothstein Kass Business Advisory Services, LLC. "Fiduciary duty and the growing compliance burden institutional investors face ensure that consultants will continue to influence institutional allocations. At the same time, regulators and legislators continue to examine these relationships."

Operational Issues

The credit crisis, combined with the ensuing legislative, regulatory and investment community response, has increased the scope and focus of investor due diligence. As we expected, more than nine out of ten hedge fund managers expect investors will engage in greater due diligence in 2011 (Exhibit 20).

Exhibit 20:

Investor focus on due diligence will increase in 2011



Agree	92.3%
Disagree	5.1%
Uncertain	2.6%

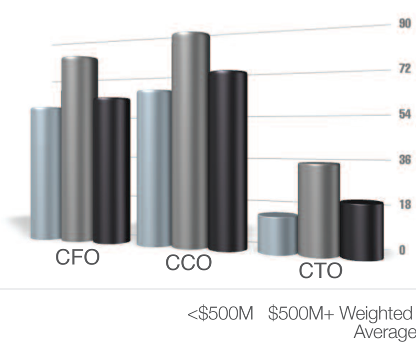
N = 313 hedge funds

"For the past two years, there has been overwhelming agreement among hedge fund managers that investors will intensify their focus on due diligence processes. While investment return was once the only consideration for high-net-worth and family office investors, today they have joined with institutional investors in demanding greater transparency in the process behind the performance," said Mr. Kollin. "Everything, including organizational structure, reporting process, technology and service provider relationships, is a factor in capital-raising efforts. This is consistent with our advice to clients to 'act institutional.'"

With a growing percentage of industry assets under management coming from institutional investors and family offices, hedge funds are also becoming more institutional in character. They are now most often firms that employ a variety of specialized executive personnel critical to effective management, including CFOs, CCOs and, to a lesser extent, CTOs (Exhibit 21). This is more in evidence among the hedge funds with $500 million or more AUM.

Exhibit 21:

Officers at the hedge fund



	<$500M	$500M+	Weighted Average
Chief financial officer	53.9%	79.8%	61.7%
Chief compliance officer	64.4%	87.2%	71.2%
Chief technology officer	14.6%	35.1%	20.8%

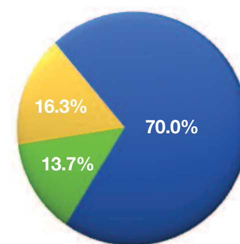
N = 313 hedge funds

"Determining the appropriate legal structure is just the first step in establishing the organizational structure of the firm. Developing, maintaining and—most important—improving institutional quality best practices is dependent on having the right personnel in place to manage for efficiency," said Mr. Pacello. "Fortunately, the allure of the industry remains strong for motivated professionals seeking a challenging and rewarding career. As the community adds to its ranks, it continues to draw talent from other segments of the financial services industry. More recently, some hedge funds have turned to the regulatory agencies themselves to find qualified candidates to oversee compliance efforts. The hedge fund sector's ability to offer extremely competitive compensation helps to support a high retention rate."

Across the board, 70% of hedge fund managers expect technology to be a greater focus in 2011 (Exhibit 22). Whether the technology is proprietary or provided by outside vendors, it's clear that technological innovation will be a key differentiator among hedge fund companies in this hypercompetitive environment.

Exhibit 22:

There will be a greater focus on technology at hedge funds in 2011 and beyond



Agree	70.0%
Disagree	13.7%
Uncertain	16.3%

N = 313 hedge funds

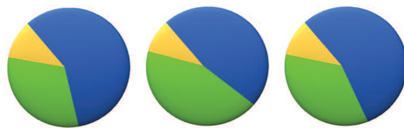
"For the past two decades, hedge funds have paced technological advancement in the asset management sector. From trading technologies that help to improve margins of return to back-office systems that help to mitigate rising compliance costs, hedge funds continue to explore and implement solutions that will improve overall operational performance," said Mr. Kollin.

Slightly more than half the hedge fund managers expect downward fee pressure (Exhibit 23), numbers consistent with those compiled for our 2010 report. This suggests that hedge fund investors continue to exert greater influence during the investment allocation process than in years prior to the crisis. Nearly 60% of hedge fund

managers anticipate that the advisory fee structure will be more closely linked to long-term performance (Exhibit 24). With the balance of power clearly tilted toward investors, nearly 70% of hedge funds predict that the industry will increasingly consider lower advisory fees in exchange for longer investment commitments.

Exhibit 23:

There will be downward pressure on hedge fund advisory fees in 2011

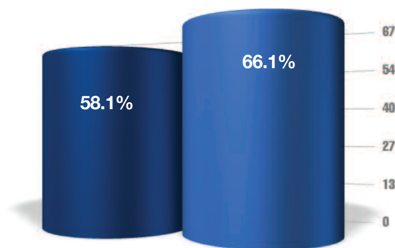


	<$500M	$500M+	Weighted Average
Agree	57.5%	46.8%	54.3%
Disagree	31.5%	43.6%	35.1%
Uncertain	11.0%	9.6%	10.5%

N = 313 hedge funds

Exhibit 24:

Hedge fund fee structure



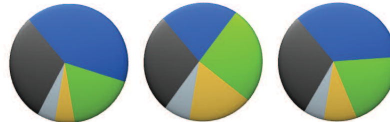
Advisory fee structure will be more closely linked to long-term performance	58.1%
Hedge funds will increasingly consider lower advisory fees in exchange for longer lock-up periods	66.1%

N = 313 hedge funds

The majority of all survey participants with less than $500 million in AUM predicted that hedge funds will be willing to consider lower advisory fees for allocations exceeding $50 million (Exhibit 25). The larger hedge funds anticipate larger allocations will be required if fees are negotiated.

Exhibit 25:

Hedge funds will consider lower advisory fees for clients



Allocations	<$500M	$500M+	Weighted Average
$50 million or more	41.1%	21.3%	35.1%
$100 million or more	17.4%	25.5%	19.8%
$250 million or more	5.4%	17.0%	8.9%
None of the above	5.0%	7.4%	5.8%
Uncertain	31.1%	28.7%	30.4%

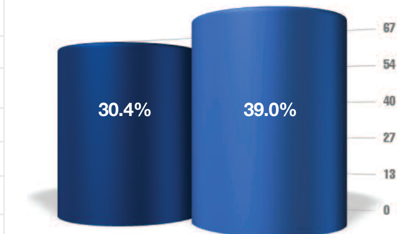
N = 313 hedge funds

"The symbiotic relationship shared by hedge fund general partners and their investors propelled the industry to heights that it is now poised to reclaim. Still, the negotiation over fees is perpetual. Before 2008, 'two-and-twenty' was the standard, with the very best managers exceeding that threshold. More recently, capital has held the advantage. The increased pace of new fund launches suggests that this trend will continue in the short term," said Mr. Altman. "New hedge funds are more frequently offering preferred rates to seed capital investors, while a growing number of established funds are extending special terms to institutional investors. These investors have sophisticated due diligence and risk measurement approaches to ensure alignment of long-term objectives, promoting greater fund stability."

About 30% of the hedge fund managers see fees charged for redemptions becoming more common (Exhibit 26). Most hedge fund managers do not expect investor-level gates to become the norm.

Exhibit 26:

Exiting the hedge fund



Hedge funds will more commonly charge fees on redemptions	30.4%
Hedge funds will increasingly establish investor-level gates instead of fund-level gates	39.0%

N = 313 hedge funds

"After many institutional investors were forced to liquidate investment positions to meet their own liquidity needs at the peak of market volatility, many were left with larger than normal concentrations of illiquid assets. This limited participation in the ensuing equity market recovery for most. A positive development from all of this is that the hedge fund community has already shown an ability to reevaluate and change its practices to make certain that it allows for an orderly redemption process that provides needed liquidity without damaging the long-term prospects of a fund itself and is fair to all investors," said Mr. Calcagno. "Examples range from allowing each investor to withdraw only a certain percentage of assets at established intervals, rather than maintaining fund-level gating, to stricter risk management of position limits as it relates to liquidity across all portfolios, more funds assessing early redemption fees

and the use of side pockets. If investors continue to respond positively to these concepts, they will become standard practice."

About half the hedge funds are expected to increasingly outsource non-investment functions in 2011 (Exhibit 27). This is much more the case with the smaller funds (64%) compared to the larger funds (35%).

Exhibit 27:

Hedge funds will increasingly outsource non-investment functions in 2011

	<$500M	$500M+	Weighted Average
Agree	63.9%	35.1%	55.3%
Disagree	22.4%	47.9%	30.0%
Uncertain	13.7%	17.0%	14.7%

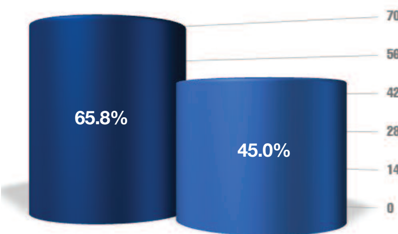
N = 313 hedge funds

"In our interactions with our hedge fund clients, one of the most repeated laments is that the increased regulatory requirements could steal focus from core asset management operations. The compliance burden stands to weigh heaviest on smaller funds, which believe one possible solution will be to outsource non-investment functions," said Mr. Altman. "Larger funds are more likely to see scale as a competitive advantage, achieving economies of scale."

With the scales of influence slanted toward investors, 66% of hedge fund managers anticipate a greater role for investor relations departments (Exhibit 28). Concurrently, 45% of hedge funds are likely to turn to outside marketing and public relations departments to bolster their brands through more effective communications strategies.

Exhibit 28:

Communicating the message



N = 313 hedge funds

Investor relations departments will be more important to hedge fund success	65.8%
Hedge fund firms will more frequently retain outside marketing and public relations consultants to improve investor communications	45.0%

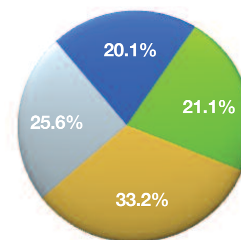
"The inflow of institutional assets from pension funds and other retirement accounts has provided 'Main Street' with access to the alternative investment community. Many hedge funds, through increased transparency, are helping these investors understand the business behind their alternative investment allocations," said Mr. Altman. "In general, hedge funds are taking the opportunity to promote an understanding of strategy and processes, in an effort to tackle persistent misconceptions about the sector, in general, and best practices."

Regulatory

Even though many of the specific elements of recently enacted regulatory reforms have not been defined, hedge fund managers are planning for likely contingencies, and some are taking action based on their analysis. One of the most controversial provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act is the "Volcker Rule," limiting proprietary trading by banks and other financial institutions. The majority of hedge funds surveyed believe that large financial institutions will spin out these operations through new hedge fund launches (Exhibit 29). There is hardly consensus on the likely course of action, however, as roughly 20% believe proprietary trading operations will be disbanded, and a similar percentage expect them to be sold.

Exhibit 29:

The "Volcker Rule" restricting proprietary trading is most likely to cause large financial institutions to:



Convert proprietary trading operations to hedge funds	33.2%
Sell proprietary trading operations	21.1%
Disband proprietary trading operations	20.1%
Uncertain	25.6%

N = 313 hedge funds

"We have already observed an uptick in hedge fund launches resulting from the spin-out of proprietary trading desks, and this is a model that seems to make sense. With adequate foresight and planning, many of these new funds are able to leverage the bank relationship in creating a solid foundation for growth. Other established

hedge funds will be strategic buyers of proprietary trading operations," said Mr. Kollin. "With so many variables potentially impacting the pace and scope of the implementation of the Dodd-Frank Act, it is difficult at this stage to ascertain how most large financial institutions will approach Volcker Rule compliance."

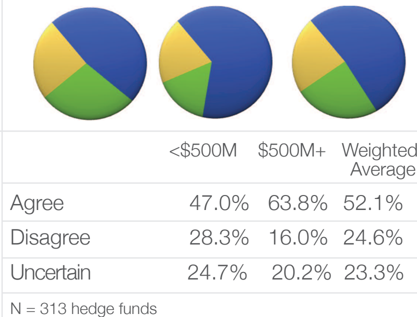
More than 70% of survey participants anticipate regulatory scrutiny of high-frequency trading practices (Exhibit 30). The use of leverage and speculation in the commodities market (where some see a bubble forming) are identified as areas relatively high in priority on the regulatory agenda. A third of hedge fund managers expect greater scrutiny surrounding the use of placement agents. About half of respondents expect the SEC to require the disclosure of short positions to regulators (Exhibit 31).

Exhibit 30:
The likely focus of the regulatory agenda

High-frequency trading	71.9%
Use of leverage	55.6%
Speculation in commodities markets	44.1%
Use of placement agents sourcing institutional capital	33.5%
Reconciliation of U.S. and international standards	24.3%
Hedge fund advisory fees	18.8%
Distressed investing practices	16.0%
Dividend tax rates	12.8%
Uncertain	8.6%
None of the above	1.3%

N = 313 hedge funds

Exhibit 31:
The SEC will require regular disclosure of short positions held by hedge funds



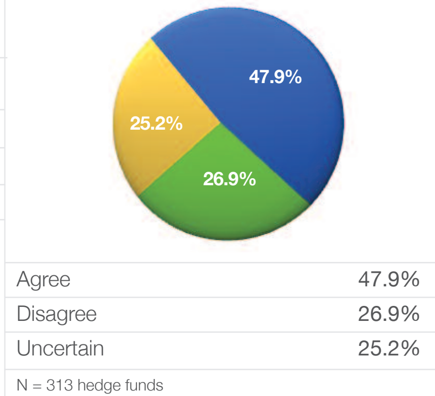
	<$500M	$500M+	Weighted Average
Agree	47.0%	63.8%	52.1%
Disagree	28.3%	16.0%	24.6%
Uncertain	24.7%	20.2%	23.3%

N = 313 hedge funds

"The regulatory focus on alternative investments in the aftermath of the crisis was likely misguided, but has ultimately led to some positive developments for the industry and its investors. The measured treatment of the industry in legislative and regulatory efforts to date is the by-product of the meaningful advocacy and educational efforts that have solidified over the past few years," said Mr. Altman. "These initiatives will serve the hedge fund community well as it continues to work alongside regulators to make sure that data gathered in the interests of providing greater transparency—such as the disclosure of short positions—does not reveal proprietary strategies."

Regulatory change always brings unintended consequences. For example, for about half the hedge fund managers, carried interest taxation will compel existing U.S. funds to relocate to states with more favorable personal income tax treatment (Exhibit 32). In all probability, sophisticated personal tax strategies will be employed to mitigate the adverse impact of carried interest being taxed as ordinary income—if this scenario came to pass.

Exhibit 32:
Carried interest taxation will compel existing U.S. funds to relocate to states with more favorable personal income tax treatment



Agree	47.9%
Disagree	26.9%
Uncertain	25.2%

N = 313 hedge funds

"As they seek to overcome budget deficits, the federal government and many states with large concentrations of alternative investment funds have debated the merits of altering the tax treatment of carried interest. Some have suggested that disparities among state tax codes could even compel hedge fund managers to pull up stakes and relocate to a more favorable jurisdiction, eliminating the very income stream these states were hoping to exploit," said Mr. Pacello. "On an international level, discrepancies between proposed European and U.S. regulatory standards have raised the specter of domicile arbitrage, as funds with global operations ponder the optimal base for their operations. At this point, it seems that such actions would be short-sighted. There is too much at stake for the global hedge fund industry to reject the call for uniform standards."

About the Author

Russ Alan Prince is the world's leading authority on private wealth, the author of more than three dozen books on the topic, and a highly-sought counselor to families with significant global resources and their advisors. He is co-author of *The Family Office: Advising the Financial Elite.*

www.RussAlanPrince.com

About the Contributors

Howard Altman is Co-CEO and the Principal-in-Charge of financial services at Rothstein Kass. He has extensive experience in the financial services arena, with particular emphasis on investment partnerships, offshore funds and broker-dealers. Mr. Altman's experience includes advice on initial hedge fund and broker-dealer organizational structure, supervision of audits, ongoing consultation with management regarding many diverse operational and tax matters, and involvement in investigative matters, including expert witness testimony. He is frequently called upon to provide input on current issues affecting the financial services community.

Howard Altman can be contacted at: 973.577.2400 or haltman@rkco.com

Vincent Calcagno is the Principal-in-Charge of Rothstein Kass' Beverly Hills office. In addition to his management responsibilities, Mr. Calcagno specializes in audit, tax and consulting engagements for hedge funds, private equity funds, venture capital funds, fund of funds, mutual funds, management companies and broker-dealers. He has extensive operational experience from his dealings in the private sector of the financial services industry. Furthermore, he chairs Rothstein Kass' Best Practices and Learning and Development committees. As part of advising clients on various regulatory considerations impacting their industry, Mr. Calcagno is a standing contributing editor to the Firm's financial services newsletter, Wall Street Argus, and a frequent speaker at capital markets conferences and webinars.

Vincent Calcagno can be contacted at: 310.887.5250 or vcalcagno@rkco.com

Kelly Easterling is the Principal-in-Charge of Rothstein Kass' Walnut Creek office. Ms. Easterling's expertise includes domestic and offshore funds, commodity pools, private equity and fund of funds. She advises clients on initial organizational structure, supervises audits and consults with management regarding various operational and audit matters. Ms. Easterling currently serves as co-CEO of the Association of Women in Alternative Investing, a San Francisco-based organization which promotes education and networking in the hedge fund, private equity and venture capital communities. In addition, she participates as a board member of the Seattle Alternative Investment Association.

Kelly Easterling can be contacted at: 925.952.8008 or keasterling@rkco.com

About the Contributors

Richard J. Flynn is a Principal and the head of Rothstein Kass' Family Office Group. A lawyer and advanced planning specialist, he advises high-net-worth clients on wealth enhancement, wealth transfer and asset protection planning. His clients include hedge fund managers, business owners and other executives, professional athletes, and entertainers. He is co-author of *Fame & Fortune: Maximizing Celebrity Wealth* and *The Family Office: Advising the Financial Elite.*

Rick Flynn can be contacted at:
917.438.3956 or rflynn@rkco.com

Jeffrey Kollin is a Principal in the Financial Services Advisory practice of Rothstein Kass Business Advisory Services, LLC. Mr. Kollin advises clients, including hedge funds, private equity fund managers, institutional investors, mutual funds and broker-dealers, on all matters, such as capital formation, infrastructure valuation, operational, technology and risk assessments, service provider evaluation, implementation of best practices, and project management.

Jeffrey Kollin can be contacted at:
917.438.3946 or jkollin@rkco.com

Christopher Mears is the Principal-in-Charge of Rothstein Kass' New York Metro Financial Services Group, and Principal-in-Charge of the firm's Roseland, New Jersey office. Mr. Mears has over 17 years of experience in financial services, with a particular emphasis on investment partnerships, offshore funds and private equity funds. He advises alternative investment clients at the initial organizational phase to address the accounting and tax matters that may have an impact on the fund, and he subsequently oversees all services provided to the fund by the Firm, including the audit and ongoing consultation regarding many diverse operational, transactional and tax matters.

Christopher Mears can be contacted at:
973.577.2304 or cmears@rkco.com

Joseph A. Pacello is a tax Principal at Rothstein Kass where he specializes in advising hedge funds, fund of funds, private equity funds, and other types of alternative investment entities on matters related to taxation and organizational structure. Mr. Pacello also advises clients on various regulatory issues impacting the financial industry.

Joseph A. Pacello can be contacted at:
973.577.2326 or jpacello@rkco.com

Rothstein Kass provides audit, tax, accounting and advisory services to hedge funds, fund of funds, private equity funds, broker-dealers and registered investment advisors. The Firm is recognized internationally as a top service provider to the industry through its Financial Services Group. The Financial Services Group consults on a wide range of organizational, operational and regulatory issues. The Firm also advises on fund structure, both inside and outside the US, compliance and financial reporting, as well as tax issues from a federal, state, local and international compliance perspective.

Rothstein Kass Business Advisory Services, LLC professionals provide value-added and result-oriented consulting services to clients across industries in the areas of strategy, operations, technology, risk, compliance, dispute resolution and investigations. Rothstein Kass Business Advisory Services, LLC is an affiliate of Rothstein, Kass & Company, P.C., a premier international professional services firm serving clients for more than 50 years.

Rothstein Kass

1350 Avenue of the Americas
New York, NY 10019
212.997.0500
www.rkco.com

California • Colorado • New Jersey • New York • Texas • The Cayman Islands